Parallel
Investment Management

Market Commentary – August 2014

It would seem that the significant geopolitical risks posed by the ongoing crises in Gaza, Iraq and the Ukraine have taken a back seat in investors' minds as confidence in the improving global economy gathers pace. This is influenced by the continuance of the loose monetary policy and low interest rate regime adopted by the central banks of developed economies since the financial crisis in 2008 which has encouraged investors to seek a higher return by investing in risk assets. The MSCI World Index posted a positive return in the quarter (up 3.3%) although the majority of the gain accrued in August. This positive trend masked some regional differences with Emerging Markets (up 8.0%) and Asia ex-Japan (up 7.9%) being the stellar performers, with a positive return in the US (up 5.5%) and Japan (up 4.3%) although the UK was essentially flat (up 0.6%). A poor return from continental Europe (down 3.9%) reflected the slower pace of recovery in the constituent economies. Second quarter GDP figures illustrate the divergence of Eurozone economies with Italy falling back into recession, the French economy was flat, and Germany – the engine room of Europe – saw an unexpectedly large fall in output. These three countries account for two-thirds of euro-zone GDP. Investor appetite for equities is not totally at the expense of investment in bonds (fixed interest securities) where marked inflows have been witnessed in 2014. In the last three months positive returns have been posted by both UK gilts (up 3.8%) and UK corporate bonds (up 2.9%) and despite the likelihood of future interest rate rises selective opportunities are likely to remain for investors.

UK

The UK remains one of the fastest growing developed economies with recent data showing the economy expanded by 0.8% in the second quarter, meaning that GDP has now risen above its pre-recession level. The continued strength of the recovery has resulted in the unemployment rate falling to its lowest level since December 2008 (6.5%) and increasing confidence has contributed to the rise of the UK housing market, prompting the Bank of England (BoE) to recently introduce measures aimed at taking some of the heat out of the market. The improving economic environment will increase pressure on the BoE to start to raise interest rates from their historic lows, although the timing of the first rise is still up for debate, particularly as inflation currently remains below target. We have also seen sterling rise to its highest level against the dollar since 2008 which has begun to impact the competitiveness and earnings of many UK companies, as evidenced in many recent company announcements. The UK equity market has made limited progress this year and we have seen a big divergence between the performance of large and mid cap stocks as investors have rotated out of the latter as valuations have become stretched and into more value orientated stocks. Whilst UK equities can no longer be regarded as cheap, strong fundamentals and attractive dividend yields will continue to provide support.

US

The US economy rebounded in the second quarter at an annualised growth rate of 4%, confirming that the weakness observed earlier in the year was an anomaly caused by extreme weather conditions and that the recovery is back on track. This is supported by rising business and consumer surveys, suggesting that current momentum should continue throughout the rest of the year. In response, the Fed continues to reduce its monthly QE asset purchases at a rate of $10 billion a month, implying an end to its tapering operation in October. For the time being at least the Fed still sees sufficient slack in the economy to keep interest rates on hold, although inflationary pressures are starting to build and markets have begun to price in the likelihood of a rise in mid-2015. The second quarter earnings season is drawing to a close, with a high proportion of companies beating earnings forecasts and the general tone of company announcements has been encouraging. This increased optimism and strength of US corporates has helped the S&P 500 index climb to new highs. Given the continued momentum in the US economy, underlying fundamentals should remain supportive of the US equity market, although current equity valuations may dampen return expectations.

EUROPE

Although the eurozone economy emerged from recession a year ago, the recovery has so far failed to gather convincing momentum and growth across the continent remains patchy and anaemic. Deflation remains an ever present threat to the eurozone recovery, with inflation falling to 0.3% in August, whilst unemployment remains close to all-time highs. In response to this, the ECB unveiled a stimulus package in June in an effort to boost growth, consisting of lowering interest rates to 0.15%, imposing negative deposit rates for banks to hold money overnight with the central bank, and the

introduction of a targeted long term lending programme (TLTRO). The ECB has also signalled its willingness to provide further stimulus and has openly discussed the potential for quantitative easing involving the purchase of asset-backed securities. European markets have come under some pressure from the events unfolding in Russia and Ukraine whilst lingering bank stability concerns resurfaced in July with the troubles of Portugal's Banco Espirito Santo. Despite the bleak economic picture, the corporate picture in Europe is more encouraging. Valuations remain attractive in a global context and are supported by selective strong earnings growth and sustainable dividend yields. A weaker euro would be a welcome boost, particularly for companies with international revenues.

JAPAN

Japanese equities have made encouraging progress since mid-May, recovering much of the weakness experienced in the early part of the year in anticipation of the sales tax increase. After growing by an annualised 6.7% in the first quarter as consumers brought forward spending, the economy contracted by 6.8% in the second quarter, though this was smaller than the 7.1% drop economists had expected. The recovery is expected to resume in the second half of the year as the structural reform "arrow" of Abenomics continues, which includes reducing the corporate tax rate and micro reform of the labour market to assist specific sectors such as healthcare and agriculture. The depreciation of the yen has been somewhat muted in 2014 partly due to its "safe haven" status as the geopolitical outlook deteriorates. This suggests the rise in Japanese equities has been driven by increased domestic activity. Furthermore, a reassessment of the investment strategy of the Government Investment Pension Fund (GPIF), the world's largest pool of pension assets, to reduce its holdings of Japanese bonds in favour of equities has the potential to provide additional support for the market. Whilst risks remain and we will have to see if Abenomics can properly halt the deflationary and low growth conditions that have plagued Japan for so many years, progress has been good so far and we feel Japan offers more potential than other developed markets at this time.

ASIA

Asian equities have performed well over the past few months due to strengthening economic data, positive political developments in India and Indonesia and a general increase in investors' sentiment towards the region. China recently reported growth figures of 7.5% year-on-year and authorities have introduced a 'mini-stimulus' package of tax cuts and accelerated infrastructure spending in an effort to support the economy. Whilst further reforms are needed, particularly to tackle growing indebtedness and a potentially overheating residential property market, the outlook for growth looks favourable, which should be positive for Asia and emerging markets as a whole. The region remains well positioned with respect to sustainably stronger economic growth, robust baking systems, positive demographics and the healthy balance sheets of both governments and consumers. However, any further concerns surrounding China's economic growth or uncertainty over eventual tightening in the US could trigger bouts of volatility.

EMERGING MARKETS

Having largely underperformed developed markets since 2010, emerging markets have recently begun to reverse this trend, outpacing developed markets so far this year. Optimism surrounding policy reform in China and a new pro-business government in India have contributed to this, whilst the general rotation towards undervalued areas of the market and increased investor risk appetite have also provided a boost. However not all emerging markets have benefitted equally. Slow growth in Latin America has weighing on the overall index as has the tensions in Russia and Ukraine, which has not only affected domestic markets but also impacted the wider emerging European region. In a surprise move, Russia's central bank raised its key interest rate to 8% in July due to concerns about inflation and the effect of the tensions on the rouble. Whilst these issues and the potential impact on global liquidity as the Fed starts to withdraw support have the potential to cause bouts of volatility in the short term, the longer term outlook remains positive.

FIXED INTEREST

Fixed interest markets have produced broadly positive returns year to date amid a backdrop of low interest rates and subdued inflation in developed economies. As a consequence we have seen yields fall in key government bond markets whilst spreads have tightened in both investment grade and high yield areas of the market. Emerging market bonds have produced some of the best returns within the asset class helped by ongoing low yields in core developed markets that have pushed investors towards higher yielding, and higher risk, areas of the market. High yield bonds have come under some pressure recently following comments made by Janet Yellen, Chair of the US Federal Reserve, around liquidity concerns and a deterioration in lending standards for some lower rate corporate issuers, resulting in a sell-off earlier in the summer. Fixed income markets will undoubtedly take their cue from central banks in the coming months as the prospect of interest rate increases in the UK and US becomes a more realistic possibility.

As expectations begin to be priced in, the exact timing of these rises will become less important than how high rates go once hikes do begin and how long the tightening cycle will last.

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